Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-6202-99
GAKindel

date: NOV 18 1999

to: Examination Division, Laguna Niguel
ATTN: Pam Douglas, International Examiner, SP:1410

from: Associate District Counsel, Southern California District, San Diego

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subject: [redacted]
Conversion of Accounts Payable to Equity

This memorandum responds to your follow-up request for advice regarding whether, for the taxable year ending September 30, [redacted], and the short-year ending December 31, [redacted], the Service should impute interest pursuant to I.R.C. § 482 on "overaged" accounts payable due from [redacted] (the "Taxpayer") to its parent.

<u>DISCLOSURE STATEMENT</u>

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether the Service has exceeded its authority by imputing interest, pursuant to I.R.C. § 482, on amounts due from the Taxpayer to its sole shareholder, [redacted], an [redacted] corporation, as a result of purchases in the ordinary course of business, where (1) the Taxpayer was not required to pay the amounts due by any specified date and (2) the Taxpayer was not required to pay any interest on the amounts due for the period during which the amounts were outstanding.

2. Whether the Service should impute interest, pursuant to I.R.C. § 482, on the amounts due from the Taxpayer to [redacted], where, according to the Taxpayer, it was not able to pay the amounts due or any interest due thereon.

3. Whether the provisions of I.R.C. § 7872 apply to the "interest free loans," described in Issue 1, above.

CONCLUSIONS

1. No. [redacted] did not charge the Taxpayer interest on the amounts due from the Taxpayer. Under I.R.C. § 482, the Service is authorized to allocate income between these parties in order to reflect an arm's length rate of interest for the use of the amounts outstanding.

2. Yes. The Taxpayer made over $[redacted] in payments to [redacted] during [redacted], [redacted], and [redacted]. Clearly, the Taxpayer was able to pay the amounts due and/or the interest due thereon.

We recommend, however, that the Service evaluate the Taxpayer's financial condition for thoroughly before reaching a final determination on this issue.

3. No.

FACTS

[redacted] (the "Taxpayer") is a California corporation wholly owned by [redacted] (the "Parent"), an [redacted] corporation. Prior to [redacted], the Taxpayer used the fiscal year ending September 30 as its taxable year. As of [redacted], the Taxpayer uses a calendar year as its taxable year.

The Parent did not conduct any trade or business within the United States during [redacted].

Prior to [redacted], the Taxpayer manufactured and sold [redacted] at the wholesale level to retail outlets and warehouse clubs throughout the United States. The [redacted] manufactured by the Taxpayer had a special [redacted] that it purchased from the Parent. Generally, the Taxpayer paid the Parent between $[redacted] and $[redacted] per kilo for the [redacted].

In [redacted], [redacted] manufacturers entered the U.S. market offering [redacted] similar to those sold by the Taxpayer but at a cheaper price. As a consequence, the Taxpayer could not sell as many [redacted] and ended [redacted] with large inventories. In [redacted], the Taxpayer ceased manufacturing [redacted] and became an importer of [redacted].

It is our understanding that the Parent did not set any terms for payment on the sale of its [redacted]. That is, the Taxpayer made payments to the Parent only when it had the funds to do so. According to the general ledger, the Taxpayer made the following payments to the Parent with respect to the accounts payable:

Date	Payment	Total
[redacted]	$ [redacted]	
Total		$ [redacted]
[redacted]	[redacted]	
Total		[redacted]
[redacted]	[redacted]	
Total		[redacted]
Total of All Payments		$ [redacted]

See General Account Number [redacted], Accounts Payable -- [redacted] for the period from [redacted] through [redacted].

The Taxpayer treated the accounts payable resulting from the purchases from the Parent as an "obligation on which no interest was charged by the parent." See letter dated [redacted], from [redacted], the Taxpayer's representative, to the Service.

The Taxpayer did not report any interest expense on its U.S. Corporation Income Tax Return, Form 1120, for the fiscal year ended September 30, [redacted]. The Taxpayer also reported on Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation, that (1) it owed the Parent $[redacted] at the beginning of the taxable year and $[redacted] at the end of such year and (2) it purchased inventory of $[redacted].[1]

The Taxpayer did not report any interest expense on its U.S. Corporation Income Tax Return, Form 1120, for the short-year ended December 31, [redacted]. The Taxpayer also reported on Form 5472 that (1) it owed the Parent $[redacted] at the beginning of the taxable year and $[redacted] at the end of such year and (2) it purchased inventory of $[redacted].

The Service is examining the Taxpayer's fiscal year ending September 30, [redacted], as well as the Taxpayer's short-year ending December 31, [redacted]. The Service proposes to impute interest on the "overaged" accounts payable pursuant to I.R.C. § 482 and to impose a liability for withholding tax pursuant to I.R.C. §§ 881 and 1442 on such imputed interest.

In rebuttal to the Service's position, the Taxpayer asserts that it was weak financially and was not able to pay the interest on the amounts owed to the Parent. The Taxpayer shows its taxable income for the taxable years ending September 30, [redacted] through December 31, [redacted], as follows:

Year Ending	Taxable Income (Loss)
[redacted]	$ ([redacted])
	([redacted])
	([redacted])
	([redacted])
	([redacted])
	([redacted])
	([redacted])

See letter dated [redacted], from [redacted], the Taxpayer's representative, to the Service. The Taxpayer argues that, as a consequence of the Taxpayer's being unable to pay the interest, the Parent was not required to accrue the interest on

[1] The Taxpayer used a fiscal year for tax purposes but used a calendar year for financial statement purposes. Therefore, the amount appearing on Form 5472 differs from the amount appearing in the financial statements.

the amounts owed and the Service is precluded from making an adjustment pursuant to I.R.C. § 482.

DISCUSSION

I. AUTHORITY OF THE SERVICE PURSUANT TO I.R.C. § 482

In our memorandum dated April 23, 1999, we set forth a detailed analysis of I.R.C. § 482 and its applicability to the facts in this case. Below we address the arguments made by the Taxpayer in rebuttal to the application of I.R.C. § 482. See the memorandum for a detailed discussion of the applicable statute and regulations.

I.R.C. § 482(a) authorizes the Service to distribute, apportion, or allocate gross income, deductions, credits, or allowances between controlled entities, if it determines that such distribution, apportionment, or allocation is necessary to prevent evasion of taxes or to clearly reflect the income of any of such controlled entities.

In this case, the Taxpayer purchased [redacted] from its Parent and incurred an indebtedness associated with such purchases for which it was not charged any interest. This scenario falls squarely within the purview of I.R.C. § 482. As such, the Service may impute interest to the Parent on the amounts due from the Taxpayer pursuant to I.R.C. § 482 and the regulations thereunder.

The Taxpayer, however, argues that the Service would exceed its authority under I.R.C. § 482 by imputing interest on the non-interest bearing accounts payable, because this adjustment is neither necessary to prevent the evasion of taxes nor necessary to clearly reflect income of the controlled entities.

> We do not believe that either of the two threshold elements necessary for the Secretary to be granted authority under Section 482 are present regarding this issue of imputed interest. First, the Section 7872 exemption from the imputed interest rules noted above should allow the Secretary to determine the "evasion of taxes" is not an issue since this type of interest free loans are permitted by statute. Second, the jurisdiction of the Secretary does not extend to the taxpayer's foreign parent company; therefore, the provision of Section 482 to "clearly reflect income" is limited to a determination of the U.S. Company income. The discussion in the Explanation of Items, Form 886-A does not address how or why an

> adjustment for imputed interest income to the foreign parent company would serve to clearly reflect the income of [redacted]. The adjustment for imputed interest would be an interest expense for [redacted] that would further deteriorate the operating results (losses) reflected in the years under examination.

See letter dated [redacted], from [redacted], the Taxpayer's representative, to the Service.

We disagree with the Taxpayer's conclusion. The allocation proposed by the Service is necessary to prevent the evasion of taxes and to clearly reflect the income of the Taxpayer, as well as the U.S.-sourced income of the Parent. By not charging interest on the "overaged" accounts payable, the Parent understated its income from U.S. sources. By doing so, the Parent avoided tax on the understated amount. At the same time, the Taxpayer overstated its income for the taxable year. But, because the Taxpayer had negative taxable income for the year even with the overstatement, the Taxpayer did not pay any taxes as a result of the overstatement. Consequently, they have avoided taxes by entering into the non-interest bearing "loan."

We also disagree with the Taxpayer's arguments in support of its conclusion. First, the Service is not precluded from imputing interest on loans made by the Parent to the Taxpayer, simply because the Taxpayer did not realize any income during the taxable year. Treas. Reg. § 1.482-1(f)(1)(ii). The Service has the authority to determine the true taxable income of a controlled taxpayer in any case where the taxable income of that taxpayer is anything other than what it would have been had that taxpayer been dealing at arm's length with an uncontrolled taxpayer. Treas. Reg. § 1.482-1(f)(1). Second, despite the Taxpayer's assertions to the contrary, the Parent is subject to the provisions of the Internal Revenue Code. Specifically, I.R.C. § 881 imposes a tax of 30 percent on any amounts received by the Parent from the Taxpayer as interest, dividends, rents, or other fixed or determinable income.[2] And I.R.C. § 6012(a)(2) imposes an obligation on the Parent to file an income tax return, if the Parent receives income which is subject to taxation under subtitle A of the Internal Revenue Code (e.g., I.R.C. § 881).[3]

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[2] I.R.C. § 881 applies to amounts received that are not effectively connected with a trade or business within the United States. We do not have any information suggesting that the Parent carried on a trade or business within the United States.

[3] The Parent, however, is not required to file a return for the taxable year if its tax liability is fully satisfied by the withholding of tax by the Taxpayer. Treas. Reg. § 1.6012-

I.R.C. § 6012(a)(2); Treas. Reg. § 1.6012-2(g)(1). Finally, the Service may impute interest on the loans from the Parent to the Taxpayer pursuant to I.R.C. § 482, regardless of whether the Service may impute interest on such loans pursuant to I.R.C. § 7872.

II. INABILITY TO PAY AS DEFENSE TO I.R.C. § 482

In rebuttal to the Service's proposed adjustment under I.R.C. § 482, the Taxpayer has raised a defense centered around its weak financial status and the principle that the Parent need not accrue interest on the debt owed by the Taxpayer when it does not have any reasonable expectation of collecting on the debt. See letter dated [redacted], from [redacted], the Taxpayer's representative, to the Service. Specifically, the Taxpayer argues that the Service is precluded from making the adjustment under I.R.C. § 482, because there was no reasonable expectancy that the Taxpayer could have made interest payments to the Parent.

Admittedly, as argued by the Taxpayer, in a prior case, the Service conceded "that [it] cannot allocate interest income to [a taxpayer] under section 482 if [the debtor's] financial condition is indeed proven to be so shaky that accrual of such interest income would have been precluded had the loans in fact provided for the payment of interest." Pitchford's Inc. v. Commissioner, T.C. Memo. 1975-75. The Tax Court, however, specifically did not express any views on the correctness of the Service's concession and accepted the Service's concession for purposes of that case only. Id. And, to date, neither the Tax Court nor any other court has expressed its opinion on the issue.[4]

We do not believe that the Service is precluded from applying I.R.C. § 482 to this case even if the Parent did not reasonably expect to receive any interest payments from the Taxpayer. As discussed above and in our previous memorandum, the Service clearly has the authority under I.R.C. § 482 to allocate income as it deems appropriate to clearly reflect income. Whether the party to whom the income is allocated must accrue that income is an issue separate and apart from whether the Service may allocate it to that party. We recommend, therefore, that the Service view this case in two parts: (1) whether the Service may allocate interest income to the Parent under I.R.C.

2(g)(2).

[4] The Taxpayer also cites to Johnson v. Commissioner, T.C. Memo. 1982-517, in support of its position. In Johnson, however, the Tax Court did not hold that the Service was precluded from applying I.R.C. § 482; it held that the taxpayer was not required "to accrue the imputed interest income in controversy."

§ 482 and (2) whether the Parent must accrue the imputed interest income in [redacted].

Under the accrual method of accounting, a taxpayer must include interest income in gross income when all the events have occurred to fix the right receive such income and when the amount of such income can be determined with reasonable accuracy. Treas. Reg. § 1.451-1(a). If, however, it is reasonably certain that the interest income will not be collected in the tax year or within a reasonable time thereafter, the taxpayer is justified in not accruing it. Johnson, T.C. Memo. 1982-517 (citing Corn Exch. Bank v. United States, 37 F.2d 34 (2nd Cir. 1930)). The determination of whether the Parent would have had a reasonable expectation of receiving interest payments from the Taxpayer is a question of fact. Pitchford's Inc., T.C. Memo. 1975-75 (citing Chicago N. W. Ry. Co. v. Commissioner, 29 T.C. 989 (1958)).

Over the years, the Taxpayer made substantial payments to the Parent towards the outstanding balance of the accounts payable account. Specifically, in [redacted], the year preceding the year at issue, the Taxpayer paid the Parent $[redacted]. During the year at issue, the Taxpayer paid the Parent $[redacted]. By making these payments, the Taxpayer demonstrated its financial wherewithall to pay the interest due to the Parent.

In addition, during [redacted], the year following the year at issue, the Taxpayer paid the Parent approximately $[redacted], $[redacted] in the first quarter and $[redacted] in the remaining three quarters. While events occurring in subsequent years are not determinative of the propriety of accruing income in the year at issue, they are helpful in testing the Service's conclusion in this regard. Pitchford's Inc., T.C. Memo. 1975-75 (citations omitted). Again the Taxpayer demonstrated its ability to pay the amounts due to the Parent.

As a consequence, the Parent will have difficulty arguing that it did not reasonably expect to receive any interest payments from the Taxpayer.

We recommend, however, that the Service consider the Taxpayer's financial condition during the year at issue, as well as during the years immediately before and after, before reaching its ultimate determination. In this regard, the Service should consider the following questions:

1. How much interest is accrued and unpaid as of December 31, [redacted]?

2. Did the Taxpayer have sufficient assets during [redacted], to pay all of its debts in full?

3. Did the Taxpayer have sufficient cash flow during [redacted], to pay the interest that accrued on the "overaged" accounts payable?

4. What caused the negative taxable income reported by the Taxpayer for the period beginning on October 1, [redacted] and ending on December 31, [redacted]?

   (Is the negative taxable income a result of deductions for actual cash outlays made during [redacted]? Or is it attributable to depreciation, amortization, inventory purchased in prior years?)

With this information, the Service can evaluate the strength of the Taxpayer's arguments.

III. APPLICATION OF I.R.C. § 7872

I.R.C. § 7872 provides a mechanism for imputing interest on certain below-market gift loans or demand loans. Under this mechanism, the imputed interest, or "foregone interest" as it is called for purposes of this section, is treated as transferred from the lender to the borrower and retransferred by the borrower to the lender as interest. I.R.C. § 7872(a). The below-market loans covered by I.R.C. § 7872 include any below-market loans made directly or indirectly between a corporation and any shareholder but do not include below-market loans made by foreign persons to U.S. persons as long as the interest income associated with the loans would not be effectively connected to the conduct of a trade or business within the United States. I.R.C. § 7872(c)(1)(C) and Treas. Reg. § 1.7872-5T(c)(2).

In our previous memorandum, we concluded that I.R.C. § 7872 did not apply to the facts of this case, because the Parent, a foreign person, lent money to the Taxpayer, a U.S. person, and the interest income associated with the loans was not effectively conducted with the conduct of a trade or business within the United States. It is our understanding that the Service has conveyed this conclusion to the Taxpayer. _See_ letter dated [redacted], from [redacted], the Taxpayer's representative, to the Service.

Nonetheless, the Taxpayer has reiterated its analysis of I.R.C. § 7872. In particular, the Taxpayer emphasizes the rationale for exempting the loans from foreign persons to U.S. persons from the application of I.R.C. § 7872 and wonders why the relationship between the lender and borrower would have any impact on this rationale.

First, the application of I.R.C. § 482 is not dependent on the application of I.R.C. § 7872. The Service may impute interest under I.R.C. § 482, regardless of whether it also may apply I.R.C. § 7872. If Congress had intended for I.R.C. § 7872 to override I.R.C. § 482 with respect to loans, it would have provided an exception to I.R.C. § 482 in the statute. And if the Treasury had interpreted I.R.C. § 7872 as overriding I.R.C. § 482, it would have included this interpretation in the regulations. Second, I.R.C. § 482 addresses different concerns than I.R.C. § 7872. On the one hand, I.R.C. § 482 focuses on preventing the shift of income among controlled parties and placing controlled taxpayers on a tax parity with uncontrolled taxpayers by determining the true taxable income of the controlled taxpayers. On the other hand, I.R.C. § 7872 focuses on determining the substance of the transaction. Loans that fall within the purview of I.R.C. § 7872 are treated as two transactions, a loan to the borrower and an additional payment to the borrower. The additional payment may consist of a gift, dividend, capital contribution, or compensation.

If you have any questions, please call the undersigned at (619) 557-6014.

MICHAEL LACKNER
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By: [signature]
GRETCHEN A. KINDEL
Attorney

cc: Michael Lackner
Assistant District Counsel, Los Angeles

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-1053-99
GAKindel

date: APR 26 1999

to: Examination Division, Laguna Niguel
ATTN: Pam Douglas, International Examiner, SP:1410

from: Associate District Counsel, Southern California District, San Diego

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subject: [redacted]
Conversion of Accounts Payable to Equity

This memorandum responds to your request for advice regarding whether, for the taxable year ending September 30, [redacted] and the short-year ending December 31, [redacted] the Service should impute interest pursuant to I.R.C. § 482 on "overaged" accounts payable due from [redacted] (the "Taxpayer") to its parent and whether the amounts imputed under I.R.C. § 482 are subject to withholding under I.R.C. §§ 1441 and 1442.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether the Service may impute interest, pursuant to I.R.C. § 482, on amounts due from the Taxpayer to its sole shareholder, [redacted], an Israeli corporation, as a result of purchases in the ordinary course of business, where (1) the Taxpayer is not required to pay the amounts due by any specified date and (2) the Taxpayer is not required to pay any interest on the amounts due for the period during which the amounts are outstanding.

2. Whether the Taxpayer is liable for withholding tax, pursuant to I.R.C. §§ 1442 and 1461, for interest imputed pursuant to I.R.C. § 482.

3. Whether the Taxpayer is liable for withholding tax, pursuant to I.R.C. §§ 1442 and 1461, for deemed/constructive payments of interest on the conversion to equity of the amounts due from the Taxpayer to [redacted].

4. Whether the Service should examine the Taxpayer's taxable year ending December 31, [redacted], and assert similar adjustments to those described in Issues 1, 2, and 3.

CONCLUSIONS

1. Yes. [redacted] did not charge the Taxpayer interest on the amounts due from the Taxpayer. Under I.R.C. § 482, the Service is authorized to allocate income between these parties in order to reflect an arm's length rate of interest for the use of the amounts outstanding.

2. Yes. We take the position that the Taxpayer need not make an actual payment of interest for I.R.C. § 1442 to apply.

3. Yes. In the Ninth Circuit, the forgiveness of accrued but unpaid interest for stock constitutes a payment of such interest. As such, the payment is subject to the withholding requirements of I.R.C. § 1442. In this case, the Service first must determine what portion of the accounts payable converted to equity constitutes accrued but unpaid interest.

4. Assuming that the facts with respect to [redacted] are substantially similar to those with respect to [redacted], the Service would be authorized to impute interest on the outstanding balance of the accounts payable under I.R.C. § 482 and to impose withholding tax under I.R.C. § 1442. The Service also would have a basis for imposing withholding tax with respect to the portion of accounts payable converted to equity that is treated as accrued but unpaid interest.

FACTS

[redacted] (the "Taxpayer") is a California corporation wholly owned by [redacted] (the "Parent"), an [redacted] corporation. Prior to [redacted], the Taxpayer used the fiscal year ending September 30 as its taxable year. As of October 1, [redacted] the Taxpayer uses a calendar year as its taxable year.

The Parent did not conduct any trade or business within the United States during [redacted]

Prior to [redacted], the Taxpayer manufactured and sold [redacted] at the wholesale level to retail outlets and warehouse clubs throughout the United States. The [redacted] manufactured by the Taxpayer had a special [redacted] that it purchased from the Parent. Generally, the Taxpayer paid the Parent between $[redacted] and $[redacted] per kilo for the [redacted]

In [redacted], [redacted] manufacturers entered the U.S. market offering [redacted] similar to those sold by the Taxpayer but at a cheaper price. As a consequence, the Taxpayer could not sell as many [redacted] and ended [redacted] with large inventories. In [redacted] the Taxpayer ceased manufacturing [redacted] and became an importer of [redacted].

It is our understanding that the Parent did not set any terms for payment on the sale of its [redacted]. That is, the Taxpayer made payments to the Parent only when it had the funds to do so. It is our understanding that the Taxpayer made very few payments on the accounts payable. The Service is going to confirm this understanding.

The Taxpayer treated the accounts payable resulting from the purchases from the Parent as an "obligation on which no interest was charged by the parent." See letter dated [redacted], from [redacted], the Taxpayer's representative, to the Service.

The following table shows the purchases made by the Taxpayer and the outstanding balance at the close of the year:

Year Ending	Purchases	Accounts Payable
[redacted]	$[redacted]	$[redacted]

See the Taxpayer's Financial Statements for years ended December 31, [redacted] through December 31, [redacted].

On occasion, the Parent made capital contributions to the Taxpayer. The following table shows the capital contributions made by the Parent:

Year Ending	Contribution	Number of Shares
[redacted]	$ [redacted]	[redacted]

The Service represents that each contribution was a conversion of accounts payable to equity. However, we could only independently verify that the contribution made in [redacted] was a conversion of accounts payable to equity. See Resolution Adopted by Unanimous Written Consent of Board of Directors of [redacted] dated [redacted].

During the third quarter of [redacted], the Taxpayer reached an agreement with the Parent for an adjustment to the purchase price for the [redacted] such that the Taxpayer only owed the Parent $[redacted] per kilo for that year. The Parent, therefore, granted the Taxpayer a credit of $[redacted]. See the Taxpayer's Financial Statement for the years ended December 31, [redacted] and [redacted]

Also, we note that the Taxpayer makes numerous "reversals," "cancellations," and other adjustments to its accounts payable. For example, on [redacted], the Taxpayer credited its accounts payable in the amount of $[redacted] for invoice #[redacted], but on [redacted] it debited its accounts payable in the amount of $[redacted] for invoice #[redacted] and credited its accounts payable in the amount of $[redacted] for that invoice. Also, on [redacted], the Taxpayer credited its accounts payable in the amount of $[redacted] for invoice # [redacted], but, on [redacted], it "canceled" the invoice and debited its accounts payable by $[redacted]. It is unclear, at this stage, why the Taxpayer made these "reversals," "cancellations," and other adjustments.

The Taxpayer reported no interest expense on its U.S. Corporation Income Tax Return, Form 1120, for fiscal year ended September 30, [redacted] The Taxpayer also reported on Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation, that (1) it owed the Parent $[redacted] at the beginning of the taxable year and $[redacted] at the end of such year and (2) it purchased inventory of $[redacted].[1]

The Taxpayer reported no interest expense on its U.S. Corporation Income Tax Return, Form 1120, for the short-year ended December 31, [redacted]. The Taxpayer also reported on Form 5472 that (1) it owed the Parent $[redacted] at the beginning of the taxable year and $[redacted] at the end of such year and (2) it purchased inventory of $[redacted]

The Service is examining the Taxpayer's fiscal year ending September 30, [redacted], as well as the Taxpayer's short-year ending December 31, [redacted]. The Service proposes to impute interest

[1] The Taxpayer used a fiscal year for tax purposes but used a calendar year for financial statement purposes. Therefore, the amount appearing on Form 5472 differs from the amount appearing in the financial statements.

on the "overaged" accounts payable pursuant to I.R.C. § 482 and to impose a liability for withholding tax pursuant to I.R.C. §§ 881 and 1442 on such imputed interest. The Service, however, does not identify the amount of the proposed imputed interest or the amount of the proposed withholding tax liability.

The Service is also considering examining the Taxpayer's taxable year ending [redacted]. The Service states that the Parent converted over $[redacted] in accounts payable to capital during this year. The Service has asked for advice regarding whether it should examine [redacted] to raise the issues proposed for [redacted].

DISCUSSION

I. APPLICATION OF I.R.C. § 482

I.R.C. § 482(a) authorizes the Service to distribute, apportion, or allocate gross income, deductions, credits, or allowances between controlled entities, if it determines that such distribution, apportionment, or allocation is necessary to prevent evasion of taxes or to clearly reflect the income of any of such controlled entities.

Specifically, the Service may make appropriate allocations to reflect an arm's length rate of interest for the use of funds, where one member of a controlled group makes an interest-free loan or a loan at less than an arm's length rate of interest to another member of the group. Treas. Reg. § 1.482-2(a)(1)(i). For this purpose, an indebtedness arising in the ordinary course of business from sales between members of the controlled group (an "intercompany trade receivable") is considered a loan between members of a controlled group. Treas. Reg. § 1.482-2(a)(1)(ii)(A)(2).

The term "arm's length rate of interest" means a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. Treas. Reg. § 1.482-2(a)(2). Treasury Regulation § 1.482-2(a)(2) provides "safe haven" interest rates based an the applicable Federal rate.[2]

Generally, the period for which interest is charged with respect to bona fide indebtedness between controlled entities begins on the day after the indebtedness arises and ends on the day that the indebtedness is satisfied. Treas. Reg. § 1.482-2(a)(1)(iii)(A). The period for which interest is charged with respect to an intercompany trade receivable, however, begins on the first day of the third calendar month following the month in which the intercompany trade receivable arises. Treas. Reg. § 1.482-2(a)(1)(iii)(B).

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[2] Because the Taxpayer was not charged interest on its outstanding accounts payable, we do not find it necessary to discuss in detail the safe haven rates.

In this case, the Taxpayer purchased [redacted] from its Parent and incurred an indebtedness associated with such purchases for which it was not charged any interest. This scenario falls squarely within the purview of I.R.C. § 482.[3,4] As such, the Service may impute interest to the Parent on the amounts due from the Taxpayer pursuant to I.R.C. § 482 and the regulations thereunder. The Service, however, should keep in mind that the Taxpayer is entitled to an interest-free period of 60 to 90 days pursuant to Treasury Regulation § 1.482-2(a)(1)(iii)(B).

We see three potential problems in calculating the interest to be imputed during [redacted]. First, the Service must account for the interest-free period described in Treasury Regulation § 1.482-2(a)(1)(iii)(B). As stated above, interest is not required to be charged on an intercompany trade receivable until the first day of the third calendar month following the month in which the intercompany trade receivable arises. For example, interest on an intercompany trade receivable arising in [redacted] is not required to be charged until [redacted] We recommend that the Service take the following steps:

1. determine the outstanding balance of accounts payable as of [redacted];
2. impute interest on this amount beginning on [redacted];
3. determine the total purchases made for each month after [redacted];
4. impute interest on these amounts in accordance with Treas. Reg. § 1.482-2(a)(1)(iii)(B).

The Service should account for any payments, if any, made by the Taxpayer as appropriate.

Second, the Service must account for "reversals" and other adjustments to the accounts payable. According to the "general ledger detail report," the Taxpayer debited its account payable repeatedly for "reversals" of invoices, "cancellations" of invoices, and other similar events. For example, on [redacted], the Taxpayer credited its accounts payable in the amount of $[redacted] for invoice #[redacted], but on [redacted], it debited its accounts payable in the amount of $[redacted] for invoice #[redacted] and credited its accounts payable in the amount of $[redacted] for that invoice. Also, on [redacted], the Taxpayer credited its accounts

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[3] I.R.C. § 7872 does not apply to the facts of this case. Treasury Regulation § 1.7872-5T(c)(2) provides that "section 7872 shall not apply to a below-market loan . . . if the lender is a foreign person and the borrower is a U.S. person unless the interest income imputed to the foreign lender . . . would be effectively connected with the conduct of a U.S. trade or business . . . and not exempt from U.S. income taxation under an applicable income tax treaty." In this case, the Parent did not conduct a trade or business in the United States during [redacted].

[4] I.R.C. § 483 does not apply to the facts of this case. Generally, I.R.C. § 483 applies to payments made under a contract for the sale of property, where all or part of the sales price is due more than 6 months after the date of sale and where some or all of the payments are due more than 1 year after the date of sale. I.R.C. § 483, however, does not apply to below-market demand loans between a corporation and its shareholder. In this case, the Parent does not set a due date for payment on the purchase of [redacted]. The resulting accounts payable are akin to demand loans, and as such, are not subject to the rules of I.R.C. § 483.

payable in the amount of $[redacted] for invoice # [redacted], but, on [redacted], it "canceled" the invoice and debited its accounts payable by $[redacted].

Third, the Service must address the price adjustment to which the Taxpayer and the Parent agreed during the third quarter of [redacted]. The parties intended the price adjustment to apply retroactively and to the entire year. See the Taxpayer's Financial Statements for the years ended December 31, [redacted] and [redacted]. As a consequence, the Service must compute the accounts payable using the revised price. The Service should not simply give the Taxpayer credit as of [redacted], the date on which the Parent gave the Taxpayer credit pursuant to their agreement.

II. APPLICATION OF I.R.C. §§ 881 AND 1442 TO IMPUTED INTEREST

I.R.C. § 881 imposes a tax of 30 percent of the amount received from sources with the United States by a foreign corporation as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

I.R.C. § 1442 provides that, in the case of foreign corporations, "there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in [I.R.C. §] 1441 a tax equal to 30 percent thereof." I.R.C. § 1441 requires all persons, in whatever capacity, having control, receipt, custody, disposal, or payment of any items of income specified in I.R.C. § 881 to deduct and withhold from such items a tax equal to 30 percent. In this case, the rate of 30 percent is reduced by the income tax treaty between [redacted] and the United States to [redacted] percent. See Income Tax Treaty Between [redacted] and the United States (1975), Article 13, Interest; see also Treas. Reg. § 1.1441-6(a).

I.R.C. § 1461 provides that every person required to deduct and withhold any tax under I.R.C. §§ 1441 and 1442 is liable for such tax and is indemnified against the claims and demands of any person for the amount of any payments made in accordance with I.R.C. §§ 1441 and 1442.

In this case, the Taxpayer has not made an actual payment of interest to the Parent. Arguably, however, the Taxpayer need not make an actual payment for I.R.C. §§ 881, 1441 and 1442 to apply.

The Tax Court has held that I.R.C. § 881 does not require actual payment of the income item and that the allocation of income pursuant to I.R.C. § 482 provided a sufficient basis for imposing the tax under I.R.C. § 881. See Central de Gas de Chihuahua v. Commissioner, 102 T.C. 515 (1994).

The Tax Court, however, expressly did not reach the issue of whether there was a requirement for actual payment for purposes of I.R.C. §§ 1441 and 1442. The Court distinguished between I.R.C. § 881, which imposes a liability for tax, and I.R.C. §§ 1441 and 1442, which provides the means for collecting that tax, and noted that these sections served distinctly separate purposes. Nonetheless, we take the position that this case supports subjecting interest imputed under I.R.C. § 482 to the withholding requirements of I.R.C. §§ 1441 and 1442. As stated above, the case stands for the proposition that an amount allocated under I.R.C. § 482 is deemed received by the foreign entity and is subject to tax under I.R.C. § 881. If I.R.C. §§ 1441 and 1442 are the means to collect on this tax, the amount so allocated should be deemed received for their purposes. To find otherwise would render ineffective the liability imposed by I.R.C. § 881. The Tax Court touched on this concern when it observed that "[a] holding that actual payment is required could significantly undermine the effectiveness of § 482 where foreign corporations are involved. Such a view would permit such corporations to utilize property in the United States without payment for such use and thereby avoid any liability under § 881." Id. at 520.

In addition to Central de Gas, we look to two other cases in support of our position that actual payment is not needed for I.R.C. §§ 1441 and 1442 to apply: Climaco and Nakamura v. Internal Revenue Service, 96-1 USTC ¶ 50,153 (E.D.N.Y. 1996) (unpublished opinion, Jan. 24, 1996) and Casa de la Jolla Park, Inc. v. Commissioner, 94 T.C. 384 (1990). In Climaco, the District Court held that the plaintiffs were required to withhold and pay a portion of the interest imputed pursuant to I.R.C. § 7872 even though they did not actually make any interest payments on the loan. The court could not discern any reason why the plaintiffs should not be required to make withholding payments. Climaco, 96-1 USTC ¶ 50,153. In Casa de la Jolla, the Tax Court rejected the petitioner's argument that I.R.C. § 1441 requires actual payment and receipt, stating that the language of I.R.C. § 1441 "contemplates imposing responsibility on a broad spectrum of persons: 'all persons, in whatever capacity acting . . . having the control, receipt, custody, disposal, or payment.'" Casa de la Jolla, 94 T.C. at 392-393 (quoting I.R.C. § 1441(a))(emphasis supplied).

Finally, we note that Treasury Regulation § 1.1441-2(e)(2) addresses the issue described above. Specifically, it provides

> A payment is considered made to the extent income subject to withholding is allocated under section 482. Further, income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under section 482 from a foreign person to a related U.S. person is considered paid to a foreign person .

Treas. Reg. § 1.1441-2(e)(2). While this regulation is not yet effective and, therefore, does not apply to the taxable years in this case, it does represent a position consistent with current applicable law on this point.[5]

III. APPLICATION OF I.R.C. §§ 881 AND 1442 TO CONVERSION

During [redacted], the Parent converted $[redacted] of the accounts payable due from the Taxpayer into [redacted] shares of stock in the Taxpayer. Arguably, the Taxpayer, in essence, paid the Parent $[redacted] in satisfaction of a portion of the amounts due to the Parent, and the Parent immediately contributed this payment back to the Taxpayer in exchange for additional stock. If the amount converted to equity is treated as a payment of the amounts due, then a portion of the amount converted should be treated as a payment of interest. See Treas. Reg. § 1.446-2 ("[E]ach payment under a loan . . . is treated as a payment of interest to the extent of the accrued and unpaid interest."); see also Estate of Ratliff v. Commissioner, 101 T.C. 276 (1993) and cases cited therein. And if a portion of the payment is treated as a payment of interest, such portion is subject to withholding under I.R.C. §§ 1441 and 1442.

We find that, in the Ninth Circuit, this argument has merit. See Fender Sales, Inc. v. Commissioner, 338 F.2d 924 (9th Cir. 1964), rev'g T.C. Memo. 1963-119. In Fender Sales, a corporation was indebted to its two shareholders for accrued but unpaid salaries. The corporation discharged the debt by issuing additional shares to the shareholders. The Ninth Circuit found that the transaction constituted a payment of salary to those individuals. In our case, the Taxpayer was indebted to the Parent for accrued but unpaid interest. The Taxpayer discharged this debt by issuing additional shares of stock to the Parent. In the Ninth Circuit's view, this transaction constituted a payment of interest to the Parent.

The Tax Court, however, has questioned and expressly not followed the reasoning of the Ninth Circuit in Fender Sales. See Putoma Corp. v. Commissioner, 66 T.C. 652 (1976), aff'd, 601 F.2d 734 (5th Cir. 1979). Nonetheless, the Service should continue to pursue the arguments made in Fender Sales where, as here, the Golsen rule would compel the Tax Court to follow the holding in Fender Sales. See Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971).

In applying I.R.C. §§ 1441 and 1442, the Service should take steps to avoid taxing twice the interest on the amounts due from the Taxpayer, once for interest imputed under I.R.C. § 482 and again for interest treated as paid pursuant to Fender Sales.

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[5] Neither the preamble to the regulation nor the regulation itself indicates that the regulation was intended to reflect a change in the Service's position.

If you have any questions, please call the undersigned at (619) 557-6014.

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